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UNITED STATES DEPARTMENT OF COMMERCE
International Trade Administration
ASSISTANT SECRETARY FOR TRADE DEVELOPMENT
Washington, D.C. 20230

SEP 25 1984

Mr. Maurice Ernst
National Intelligence Officer
for Economics
Central Intelligence Agency
Room 7E47
Washington, D.C. 20505

Dear Mr. Ernst:

Pursuant to our meeting of Wednesday August 22, 1984 enclosed are the "Executive Summaries" of papers on Mexico and South Korea's medium term trade outlook which I think you'll find interesting. Each reviews the prospects for trade surpluses in these countries over the medium term and how this may affect trade and investment policies.

As I think these papers raise a number of broader issues which we will have to address, I have provided copies to Treasury for review by the IG-IEP at an appropriate time. The full texts, which are some 200 pages of analysis, are available upon request from my office by calling 377-1461.

I welcome any comments you might have on these summaries, specifically with respect to the general trade or debt issues they raise.

Sincerely,

H.P. Goldfield

Enclosures

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"KEY CONCLUSIONS"

OF

"MEXICAN TRADE AFTER THE DEBT CRISIS"

A Study Prepared by

Office of Trade and Investment Analysis
International Trade Administration
U.S. Department of Commerce

August 1984

Classified by: James P. Moore, Jr.
DAS/TIA
Declassify on: OADR
September 24, 1984

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Key Conclusions

(FOUO) Despite an impressive financial recovery since the 1982 economic crisis, Mexico's $90 billion foreign debt will continue to burden its economy and distort its foreign trade for the foreseeable future. Under most interest rate and bank lending assumptions, massive interest payments--ranging from $11-13 billion annually--will remain a drain on Mexico for many years.

(FOUO) Mexico must sustain merchandise trade surpluses of around $10 billion annually to meet these interest payments and slow the growth of external debt. Merchandise trade must now bear the brunt of adjustment in the external account, even though it was mostly capital flight and rising debt servicing costs rather than trade deficits that caused the external debt build-up. Other earnings (e.g., border trade, tourism) are too small to make a major contribution. Continued large trade surpluses will also be necessary if Mexico is to fully restore its creditworthiness and hasten a resumption of voluntary bank lending.

(C) Our study suggests that sustained surpluses of the required magnitude cannot be achieved primarily through rapid Mexican export growth--leaving Mexico with the less desirable alternative of continued import restraint. Likely export growth rates will permit only a gradual recovery of imports from currently depressed levels. Overall export revenues will be constrained by the following:

(FOUO) o Through 1985, growth in oil revenues, currently 75 percent of total export earnings, will probably remain modest.

(FOUO) o Given the present small base of about $5 billion, even robust growth of non-oil exports will likely increase total revenues by only about $1.3 billion in 1984 and a further $1 billion in 1985.

(C) o Toward the end of the eighties, assuming increased oil demand, oil export performance will improve somewhat, but these gains will be partially offset by a leveling-off of non-oil exports. The analysis indicates that the recent unprecedented strong improvement in non-oil export performance is likely to be transitory, reflecting a temporary convergence of increased world demand, larger exportable surpluses due to depressed Mexican demand, and an improvement in price competitiveness.

(C) The recent non-oil export success has obscured the fact that, to a large extent, the broad-based, structural adjustments necessary to sustain a strong non-oil export drive are still deficient in Mexico. Basic macroeconomic export incentives--a competitive exchange rate, liberalized

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trade policies, and an adequate supply of funds for export capacity expansion--are weak or weakening:

(FOUO) o price competitiveness is diminishing due to renewed appreciation of the peso in real terms;

(FOUO) o high barriers to imports protecting import-competing industries are likely to reduce the incentive to venture outside the domestic market once Mexican growth resumes; and

(FOUO) o legal and administrative impediments to foreign direct investment are preventing this source of capital from contributing significantly to the role formerly played by foreign loans.

(C) Mexico is in danger of falling into the unfortunate pattern of substituting less efficient and more distortionary sectoral export performance requirements for market-based, economy-wide export incentives.

(U) In addition, exports in certain key sectors face specific problems which are not likely to be resolved quickly:

(U) o agricultural exports continue to be vulnerable to periodic droughts;

(U) o in-bond industries are experiencing emerging labor shortages due to high wage alternatives across the border;

(FOUO) o the absorptive capacity of the U.S. and other industrial markets is limited in certain import sensitive areas like steel; and

(U) o expanded world supplies of some minerals and crude materials continue to exceed demand, reducing the benefits to Mexican export prospects of the spreading world recovery.

(U) To the extent that export gains are limited, Mexican import growth will also remain depressed.

(FOUO) o Many imports will continue to be strictly controlled to generate the trade surpluses required to meet interest payments.

(C) o A further dampening of imports--above and beyond that mandated by interest costs--may result from continued weak demand throughout the Mexican economy in the likely event that strong export-led economic growth fails to materialize.

(FOUO) Import demand will not reach the very high levels of the oil boom period for many years. Mexican imports will likely remain at the low level of $10-11 billion through 1985. Lower world interest rates would shrink the size of the required trade surpluses, allowing import increases. But a return to the 1981 peak import level of $24 billion is unlikely before 1990 at the earliest.

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(FOUO) Our medium-term assessment assumes no substantial increases in world interest rates, continued increases in world demand for Mexican products, and continued Mexican access to major markets. These factors are largely beyond Mexico's control and strongly influence its export and financial prospects. If any of these key external variables move in the wrong direction, Mexico would find itself in a still more difficult position.

(FOUO) A major hike in interest rates would be especially destabilizing, since this would quickly inflate Mexico's annual interest costs and the size of the trade surpluses required to meet these payments.

(U) o Each 1 percent rise in interest rates adds about $700 million to Mexico's interest payments.

(FOUO) o Interest rate increases thus far in 1984 are expected to boost Mexico's annual interest payments by about $1 billion, almost as much as the entire projected increase in non-oil export revenues.

(C) If all vital external factors remain favorable as assumed, then the required trade surpluses are probably achievable. These surpluses may well restore lender confidence and slow debt growth, but they are not likely to be accompanied by a broad-based rekindling of rapid economic growth or a generalized improvement in the international competitiveness of Mexican industry and agriculture.

(C) The interest payment outflow and associated trade surpluses (equal to 5-7 percent of GDP) will continue to divert financial resources from development. The possibility for a prolonged low-growth/high-trade-surplus adjustment path brings with it two substantial risks: rising social tensions as living standards remain flat or increase only minimally, or a return to earlier patterns of stimulative increases in government expenditures and accelerating inflation.

(FOUO) Mexico's ongoing dilemma will continue to have negative effects on the U.S. economy and will pose serious trade policy problems for the U.S. Government.

(FOUO) o U.S. border areas dependent on the Mexican market will likely suffer continued economic dislocation as the hoped for robust recovery in Mexican growth and imports fails to materialize.

(FOUO) o U.S. companies which have relied heavily on sales to Mexico will also continue to be hurt by Mexican import limits.

(FOUO) o Pressures for illegal migration will not diminish, but will likely increase as Mexican per capita income stagnates.

(FOUO) o Mexican attempts to penetrate import sensitive markets may well intensify; market disruption and unfair trading practice charges will likely proliferate.

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(FOUO) o Mexican import restraint--particularly when implemented through quantitative restrictions--will fuel demands for reciprocal access to the Mexican market.

(FOUO) Although an early return to pre-1982 Mexican trade patterns is not expected, a combination of the following could significantly improve the outlook.

(U) o Major reductions in interest costs would allow corresponding reductions in the size of the required trade surpluses.

(FOUO) o Significant changes in Mexican attitudes and policies toward foreign direct investment (FDI) might encourage additional FDI in non-oil export-oriented sectors. Existing FDI in Mexico is responsible for a major share of manufactures exports.

(C) o A sustained Mexican commitment to more realistic, market-determined internal pricing and exchange rate policies would provide stronger price incentives for exports, reducing the need for quantitative import controls, expensive export subsidies, and export performance regulatory requirements. Such policies would remove an important rationale for import restrictions in import sensitive industrial country markets. Further, disadvantages faced by Mexico's private sector in obtaining import permits for key imported production inputs and capital equipment would be reduced. Finally, the potential for conflict in Mexico's trade strategy, between the stated priority of non-oil export development and the favored import-competing production protected by high import barriers, would be diminished.

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SOUTH KOREA'S FOREIGN TRADE: TRENDS AND PROSPECTS

This report is an analytic document and should not be construed as a statement of Department of Commerce policy

OFFICE OF TRADE AND INVESTMENT ANALYSIS

August 7, 1984

U.S. DEPARTMENT OF COMMERCE
International Trade Administration

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STAFF REPORT

SOUTH KOREA'S FOREIGN TRADE: TRENDS AND PROSPECTS

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DIE-04-84
May 1984

Office of Trade and Investment Analysis
International Trade Administration
U.S. Department of Commerce

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FOREWORD

Nations facing high levels of external debt must manage their external adjustment largely through their merchandise trade accounts--by expanding exports and/or by reducing imports.

This study is one of a series examining the international trade performance and prospects of major developing debtor nations. The objective of these analyses is to anticipate likely changes in the volume, composition, and direction of trade of individual debtor countries.

To achieve these objectives, the subject country's trade is examined on a disaggregated basis. Probable trends in its exports and imports of major import and export items are then projected. This methodology requires the collection, analysis, and presentation of large amounts of data and qualitative information concerning trade in individual items and the identification of those factors that will affect future trade in these items.

This paper provides the results of the initial examination of South Korea's trade performance and prospects. To extend its usefulness, subsequent editions are planned to update and refine the information and analysis contained in this initial paper.

Comments, suggestions, and additional data for improvement of succeeding editions are solicited.

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SUMMARY

- South Korea has successfully pursued a strategy of export-led economic growth over the last two decades. Exports of goods and services--totalling $30 billion in 1983--accounted for over 40 percent of South Korea's GNP in the last three years, compared with only 5 percent in 1961.

- Korea's aggressive, outward-looking growth strategy contrasts sharply with the inward-looking, import substitution policies followed by most other heavily-indebted third world nations.

- Like other LDCs, Korea's economic development has been speeded by trade deficits financed by rapid growth in external borrowing. At $40 billion as of the end of 1983, Korea's debt was fourth largest in the developing world.

- About $26 billion of Korea's total external debt accrues interest at floating rates. Thus each one percent increase in the LIBOR/U.S. prime rate costs Korea about $263 million annually.

- Since a high proportion of Korea's total debt--$14 billion or 36 percent--consists of short-term credits that must be consistently refinanced, Korea is vulnerable to financial market tremors and/or a contraction of credit that could result from factors unrelated to Korea, including spillovers from debt problems in Latin America and elsewhere.

- To strengthen financial market confidence and reduce its vulnerability, Korean policymakers have shifted economic policy toward maintaining strong, steady growth at lower rates of inflation to narrow Korea's annual trade and current account deficits and slow the rate of debt accumulation.

- Korea's 1983 economic performance--9.3 percent real GNP growth 2 percent inflation, 11.9 percent export growth, and declining trade and current account deficits--shows that the economy is firmly on this course.

- However, because of its high degree of export dependence, its growing reliance on the U.S. market, Korea's economy remains highly vulnerable to international factors beyond its control.

BALANCE OF PAYMENTS TRENDS

- Buoyant export recovery combined with moderate import growth trimmed Korea's merchandise trade deficit to $1.6 billion in 1983, compared with the $4 billion average annual deficit of 1979-81. Based on our projected export and import growth rates of 13.3 percent and 9.8 percent, respectively, Korea's merchandise trade deficit should decline further to $1.2 billion in 1984.

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- In 1985-86, however, we project that higher imports and a slight tapering off of export growth will cause the trade deficit to increase slighly, rather than move toward a surplus position has targeted in the recently revised Korean Five-Year Plan.

- In recent years, Korean foreign exchange earnings have been bolstered by receipts from overseas construction--mostly in the Middle East. However, declining Middle East oil revenues in 1982-83 dealt a serious blow to overseas Korean construction activities. Despite the signing of a $3.3 billion contract with Libya in November 1983, total new contracts for the year declined by 22 percent to $10.4 billion. Cutbacks in overseas construction will affect not only earnings from engineering and construction services but also merchandise exports linked to these foreign construction projects.

- On the assumption that interest rates will average 1.5 percentage points higher in 1984-86 than in 1983, interest costs on Korea's foreign debt are projected to rise to $3.0-3.2 billion per year.

- Based on the expected widening of Korea's merchandise trade deficit, shortfalls in overseas construction receipts and higher interest payments, our projections indicate that Korea's overall current account deficit will widen slightly between 1984 and 1986, rather than move into a surplus position as envisioned in the Five-Year Plan.

- Foreign direct investment has played a very small role in Korea's development--averaging only 5 percent of total long-term capital inflows over the last 20 years. Nonetheless, increased foreign direct investment could augment needed foreign capital inflows without adding to Korea's outstanding external debt and interest payments.

MERCHANDISE EXPORT PERFORMANCE

- Rapid development of new export industries, aggressive penetration of foreign markets, and an elaborate system of export promotion policies and incentives enabled Korea to achieve an impressive 34 percent average annual growth in merchandise exports over the period 1961-82.

- Korea's merchandise exports expanded 11.9 percent in 1983 to $24.4 billion, the largest export value of any non-oil developing country.

- The dollar value of Korea's total 1984-86 merchandise exports is projected to increase at an average rate of 12.9 percent, somewhat slower than the 15 percent growth envisaged in revised Five-Year Plan.

- The U.S. absorbed one-third of total Korean exports in 1983, while another third went to other OECD countries. Approximately 90 percent of Korean exports are manufactured goods, for which export volumes are sensitive to world economic conditions and protectionist pressures.

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- High export concentration in the U.S. and other industrial countries--and consequently the dependence on OECD economic expansion--is the greatest single vulnerability in Korean export performance. A recession in the U.S., with its resulting impact on the economies of other industrialized countries, could cut Korea's projected annual export growth rate in half.

- On the positive side, Korea is much less vulnerable to the sharp commodity price swings that have devastated the export performance of many other developing nations.

- During the 1970s, Korea diversified its export mix away from predominantly light industry products--textiles, footwear, clothing--and became a highly successful exporter of heavy industrial goods, including steel and ships. A further transition is now underway to an emphasis on exports of electronics and electrical machinery products.

- Rapid development of electrical machinery and electronics exports is particularly vital in view of the limited growth prospects for several important Korean exports. Growing import restrictions in major markets and increasing competition from lower-wage LDC producers will cause a slowdown in the growth of light industrial exports.

- Exports of Korean steel products will grow more slowly due to excess world steel capacity and protectionist pressures. The shipbuilding industry, which added over $3 billion to Korean exports in the last three years, is also projected to achieve much slower growth in 1984-86, owing to weak world demand for ships.

- We project that exports of electrical machinery will expand at a 22 percent average annual rate in 1984-86, and will account for one-fourth of the overall increase in Korea's exports over this period--twice its share of the total 1983 export value. Current Korean trade targets call for even more rapid growth--an average annual increase in electrical machinery exports of over 30 percent.

MERCHANDISE IMPORT PROSPECTS

- Capital goods accounted for over one-fifth of Korea's total imports through the mid-1970s, but their share subsequently declined as the oil imports increased. The share of imports required to support production for export has risen steadily over the last two decades and is now probably about one-third of the total.

- Merchandise imports are projected to grow at an average rate of 12.2 percent per year in 1984-86, with the largest increases in machinery and equipment. On the assumption of moderate oil price increases through 1986, the share of oil in total imports is projected to fall to 21.6 percent, from a peak of 27.8 percent in 1982.

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- If crude oil prices jump to $44 a barrel by 1986, rather than the $ 33 assumed in baseline projections, Korea's oil costs could be over $2 billion higher. However, Korea is rapidly diversifying its energy sources, increasing the share of coal and nuclear power.

U.S.-KOREAN TRADE RELATIONS

- The U.S. has provided 20-25 percent of total Korean imports over the past decade. In 1982, the U.S. replaced Japan as the leading source of Korea's imports for the first time since 1965.

- Korea's strong 1983 export performance based largely on increased sales to the United States. The $2.0 billion increase in exports to the U.S. (to a total of $8.2 billion) represented over three-fourths of the overall increase in Korea's exports.

- For the past two decades, Korea has typically run a trade deficit with the U.S. In 1983, however, the balance swung to a $2.0 billion Korean merchandise trade surplus (Korean statistics on a customs clearance basis--$1.4 billion according to U.S. merchandise trade statistics). Our projections indicate that Korea's trade surplus with the U.S. will widen further in 1984.

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